POINT PAPER

ON

MILITARY FAMILY TAX RELIEF ACT OF 2003

- On Veterans' Day, President Bush signed the Military Family Tax Relief Act (MFTRA) of 2003, extending specific tax benefits to active duty and Reserve and National Guard personnel and their family members. This paper summarizes each category of relief and provides practice tips and guidance for legal assistance attorneys and tax program managers.

- The Act effects changes to the Internal Revenue Code in the following areas of interest to individual military taxpayers and their family members:

-- 1) Exclusion of Capital Gain on the Sale of a Principal Residence;

-- 2) Exclusion from Gross Income of Death Gratuity Payments;

-- 3) Exclusion from Gross Income of Amounts Received under the DoD Homeowners Assistance Program;

-- 4) Expansion of Combat Zone Rules Pertaining to the Filing of Income Tax Returns to Contingency Operations;

-- 5) Clarification of the Treatment of Certain Dependent Care Benefits;

-- 6) Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts;

-- 7) Above-the-line Deductions for Overnight Travel Expenses of National Guard and Reserve Members.

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- **Exclusion of Capital Gain on the Sale of a Principal Residence**: The Act allows a taxpayer to elect to suspend for up to 10 years the running of the 5-year assessment period for determining eligibility to exclude capital gain from gross income following the sale or exchange of a home.

-- Impact: Generally, a taxpayer may exclude up to $250,000 (single filers) or $500,000 (married filing jointly) of gain from the sale of a property owned and used as a principal residence for at least 2 years of the 5 years preceding the sale. Under the new law, if the election is made the 5-year period ending on the date of sale or exchange does not include any period of up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services.

--- The term "qualified official extended duty" includes any period of military service at a location at least 50 miles away from the taxpayer's elected principal residence or under orders compelling residence in Government-furnished quarters. This provision covers active duty personnel required by orders to move more than 50 miles from their principal residence or to reside in Government quarters. Reserve and National Guard personnel called to active duty for a period of more than 90 days and sent to a location more than 50 miles from the principal residence or required to reside in Government quarters may also elect to take advantage of the protections this provision affords.

--- For both active duty personnel and reservists and Guard members called to active duty, the election to suspend the 5-year assessment period may be made for only one property. The taxpayer remains free to change the election to a different property. The statute does not indicate how this election will be communicated to the IRS. As of 15 December 2003, the IRS had yet to publish a regulation or disseminate other guidance on the election. JACA will advise the field as soon as such guidance becomes available.

-- **Timeline**: This provision applies to sales occurring after 6 May 1997. Normally, a taxpayer cannot claim a tax refund more than 3 years after the closeout of the tax year. However, Congress specifically incorporated a 1-year period, running to 12 November 2004, for taxpayers to amend returns and claim refunds to which they've become entitled as a result of this provision. **It is vitally important to get the word out specifically on this change in the law. Military taxpayers may now be eligible to exclude some or all of the capital gain included in their gross income on a previous return**. Publicizing the 1-year waiver of the applicable 3-year limitations period is essential.

-- **Practice Tips**:

--- a) In most cases, the general rule on excluding capital gain on the sale of a principal residence will suffice to protect military taxpayers from tax liability. After all, the allowable exclusions are very high - $250,000 for single filers, $500,000 for married filing jointly.

--- b) Even if a taxpayer does not meet the standard of 2 years of ownership and use as a principal residence during the 5 years preceding the sale of the property, the IRS confirmed earlier in 2003 that eligibility for a reduced exclusion is available. Thus, a taxpayer who owns and uses the property for less than 2 years can exclude that portion of the maximum exclusion amounts that is equal to the actual time of ownership and use. An example illustrates the point: If a taxpayer owns the home and uses it as a principal residence for just 1 year of the 5 years preceding sale, he or she will still qualify for half the total allowable exclusions. One year is half of the 2-year requirement to qualify for the full exclusion. In this case, the taxpayer could exclude up to $125,000 if a single filer, $250,000 if married filing jointly. In most cases, the reduced exclusion will save our clients from having to pay tax on capital gain where a move required by military service causes them to sell their home before they've resided in it for 2 years.

--- c) The new provision will most benefit taxpayers who do not wish to sell the property at the time military service compels a move. Many reasons exist for why a taxpayer may not want to sell, including prevailing market conditions, a hope that the house will appreciate in value over time, or a preference to rent the property and thereby derive income for a time. In such cases, the taxpayer can elect to take advantage of the suspension of the 5-year assessment period for that property. Any time during which the taxpayer is absent from the property due to military orders requiring a move of greater than 50 miles away or into Government quarters will not count when calculating whether the taxpayer owned and used the property as a principal residence for 5 years prior to the date of sale. Remember--the maximum extension period is 10 years.

--- d) When a taxpayer elects to suspend the 5-year assessment period for a particular property, he or she remains free to rent the property and take appropriate deductions for depreciation against rental income. In all cases, depreciation the taxpayer takes or could have taken will be recaptured at the time of sale. So, a taxpayer is well advised to calculate appropriate depreciation and take the allowable deductions from the rental income generated by the property.

--- e) Questions will abound on how this new provision operates and how it applies to individual clients' specific circumstances. Examples published by the IRS provide scenarios legal assistance practitioners and tax program managers may use when considering a particular client's situation. They are reproduced immediately below.

---- Example #1 — Lt. Green owned a house in Georgia and lived there from December 1988 until deployed overseas in January 1991. When he returned to the United States in July 1999, he was stationed 90 miles from the house. Preferring not to commute this distance, he sold the house four months later, realizing a gain of $150,000. Because he had not used the house as his principal residence during the 5 years preceding the sale, he reported this capital gain on his 1999 return. Under the new law, he can disregard both the 8½ years he was overseas and the 4 months after his return to the States, since he was stationed more than 50 miles from old residence. His five-year test period for ownership and use now consists of the 5 years before January 1991, when he went overseas. Since he owned and lived in the house for more than two years during this test period, he may exclude the gain on the sale. He must file an amended return by 12 November 2004, to recover the capital gain tax paid on the 1999 return.

---- Example #2 — Assume the same facts as Example #1, except that when Lt. Green returned to the U.S., his duty station was 40 miles from the house. Only the time overseas may be disregarded, because his duty station after returning to the U.S. was within 50 miles of the old residence. His five-year test period for ownership and use now consists of 4 months in 1999 and the 56 months before January 1991, when he went overseas. Since he lived in the house for more than two years during this test period, he may exclude the gain on the sale. He must file an amended return by 12 November 2004, to recover the capital gain tax paid on the 1999 return.

---- **Example #3 —** Col. White owned and lived in her Ohio house for three years before being stationed overseas in January 1988. She was still overseas when she sold the house in January 2003. She may disregard only 10 of her 15 years overseas, so her 5-year test period consists entirely of years in which she did not live in the house, leaving her not eligible for the home sale exclusion.

---- **Example #4 —** Sgt. Brown owned and lived in a Virginia townhouse for 10 months before being deployed overseas in February 1991. She returned in 1995 and lived in the townhouse for 16 months before she was assigned to a Texas duty station in late August 1996. She married and when the couple returned to Virginia in July 1999, they bought a nearby house. In July 2001, they sold the townhouse. Having lived in the townhouse only one month in the five years preceding its sale, they reported the capital gain on their 2001 return. Under the new law, they may disregard the time spent overseas and in Texas when determining the 5-year test period, which would then consist of the two years from July 1999 to July 2001, when they lived nearby, the 16 months she lived in the townhouse in 1995-96, and the 20 months before the February 1991 overseas deployment. During this test period, Sgt. Brown owned and lived in the townhouse for 26 months, so she may exclude up to $250,000 of gain on its sale. Because her husband never lived in the townhouse, he does not qualify for any exclusion. The Browns have until 15 April 2005, to file an amended return claiming a refund of the capital gain tax paid on the excludable amount.

--- f) You may access IRS materials on the Military Family Tax Relief Act of 2003 at the following links:

---- Highlights of Statute: http://www.irs.gov/newsroom/article/0,,id=118104,00.html

---- IRS Helps Military Personnel Get New Law's Tax Breaks:
http://www.irs.gov/newsroom/article/0,,id=118106,00.html

----- This news release provides guidance on two provisions – the death gratuity increase with fully tax-free status and the extension for up to 10 years the 5-year assessment period for determining eligibility to exclude capital gain from income on the sale of a principal residence. Of note, both of these provisions have retroactive effect, meaning affected taxpayers will be able to amend returns from prior years to secure refund of taxes paid. The IRS is expediting handling of these amended returns. Taxpayers should note "Military Family Tax Relief Act" in red ink at the top of the Form 1040X when filing. When assisting these clients, access the Form 1040X at http://www.irs.gov/pub/irs-fill/f1040x.pdf and the instructions for that form at http://www.irs.gov/pub/irs-pdf/i1040x.pdf. Taxpayers will need a copy of the previously filed return to transpose the figures to the Form 1040X. If they no longer have a copy, taxpayers should request one either by calling the IRS at 1-800-829-1040 or by filing the Form 4506, accessible at http://www.irs.gov/pub/irs-fill/f4506.pdf. You may access general information on obtaining tax return transcripts and copies at http://www.irs.gov/individuals/article/0,,id=110571,00.html.

--- g) We will encounter clients who are able to file amended returns to exclude capital gain previously reported and taxed as income. For those who sold the residence and reported the gain more than 3 years ago, the new law waives the traditional 3-year statute of limitations for amending returns and claiming refunds for a 1-year period from 11 November 2003. Since that date is a federal holiday, the period expires on 12 November 2004. **Advertise this deadline on a repeated basis throughout the year!** Use all available forums - newspaper articles, preventive law handouts, Wing staff meetings, office websites, and like education and training opportunities.

- **Exclusion from Gross Income of Death Gratuity Payments**: The MFTRA increases the value of the death gratuity benefit to $12,000 from the previous amount of $6,000 (10 U.S.C. §1478(a) as amended by the MFTRA, §102(a)(1)).

-- **Impact**: Gross income does not include "qualified military benefits," which consist of any allowance or other in-kind benefit, aside from use of a vehicle, received by a member or former member of the armed forces or his or her dependent(s). Under the Internal Revenue Code of 1986, a qualified military benefit does not include any modifications or amendments made after 9 September 1986 (26 U.S.C. §134(b)(3)(A)). The death gratuity stood at $3,000 at that time. However, section 101(b) of the Code allowed employers to provide a tax-free death benefit of up to $5,000 to employees. This provision allowed the entire death gratuity amount to be excluded from gross income when it increased to $5,000. Congress repealed section 101(b) in 1996, reverting the death gratuity's tax treatment to section 134. Again, that provision locks "qualified military benefits" at September 1986 levels, meaning any amount of the death gratuity exceeding $3,000 became subject to taxation. Thus, from 1996 on, $3,000 of the death gratuity remained tax-free and $3,000 was taxed as income to the recipient. The MFTRA provides that any post-9 September 1986 adjustments to the amount of the death gratuity payable under military death benefit provisions (Chapter 75 of Title 10) are not subject the limitation imposed by Internal Revenue Code section 134(b)(3)(A) (26 U.S.C. §134(b)(3)(C) as amended by the MFTRA §102(b)(1)). As a result, the enhanced death gratuity of $12,000 is completely tax-free. Any future increases will also remain fully excludible from gross income and therefore tax-free.

-- **Timeline**: The increase in the amount of the death gratuity is effective 11 September 2001 and applies to all deaths on active duty occurring on or after that date. The provision rendering the entire amount of the death gratuity benefit excludible from gross income also applies to deaths occurring after 10 September 2001.

-- **Practice Tips**: Beneficiaries of the death gratuity benefit for personnel who have died on active duty from 11 September 2001 onward are eligible for an additional payment of $6,000. The entire $12,000 benefit is now tax-free. If these beneficiaries filed income tax returns reporting $3,000 of the original $6,000 payment as taxable income, they may now amend that return to reduce their gross income by $3,000. That means money back from the Treasury!

--- The death gratuity is paid for deaths on active duty generally. The member need not be deployed. Nor must death be caused in training or in the performance of military duties. Thus, any beneficiary who received the original $6,000 death gratuity is now eligible for an additional $6,000 payment tax-free. These beneficiaries should file an amended tax return to reduce their gross income by the $3,000 of the original $6,000 payment that is now tax-free as well.

--- A wrinkle to consider for the surviving spouses of personnel who died in, or as a result of injuries, illness, or wounds sustained in, a combat zone or qualified hazardous duty area on or after 11 September 2001: tax forgiveness for the year of death may result in no or little income to report for the military member. If the joint return did not have taxable income even with the then taxable $3,000 portion of the death gratuity payment, no tax was paid on that amount. Thus, there would be no entitlement to a refund and no need to amend the return.

--- Amended returns are filed using the Form 1040X. Affected taxpayers will need a copy of their original return to transpose the relevant figures to the Form 1040X. Again, gross income will be reported as $3,000 lower than on the original return. Taxpayers who do not have a copy of the original return may request a copy from the IRS by calling 1-800-829-1040 or by filing a Form 4506 (accessible at http://www.irs.gov/pub/irs-fill/f4506.pdf). You may access general information on obtaining tax return transcripts and copies at http://www.irs.gov/individuals/article/0,,id=110571,00.html. When assisting these clients, access the Form 1040X at http://www.irs.gov/pub/irs-fill/f1040x.pdf and the instructions for that form at http://www.irs.gov/pub/irs-pdf/i1040x.pdf.

- **Exclusion from Gross Income of Amounts Received under the DoD Homeowners Assistance Program**: The Act excludes from gross income payments by the DoD to its members under the Homeowners Assistance Program (HAP).

-- **Impact**: Under the HAP, DoD may make payments to members of the armed services to offset a decline in housing values due to military base realignment or closure. As an example, if a house near an installation held a value of $200,000 before a base closure but only $125,000 after the closure, DoD may provide the military homeowner with a payment to offset part of the $75,000 diminution in the fair market value of the property. Formerly, such payments were treated as compensation for the receiving military members, included in gross income and subject to taxation. The MFTRA renders these payments tax-free.

-- **Timeline**: This provision applies prospectively only, with an effective date of 11 November 2003.

-- **Practice Tips**: Because of the prospective effect, military taxpayers who received these payments and paid tax on the amount received as income may **not** amend previously filed returns. The existing law at that time treated the HAP payment as income. Therefore, a tax liability was appropriate.

--- This provision will assume significance in the not too distant future if the projected round of base realignment and closure determinations occurs as planned in 2005. Should realignments and closures take effect, military homeowners who qualify for payment under the HAP will not have to include the amount received as income for tax purposes.

- **Expansion of Combat Zone Rules Pertaining to the Filing of Income Tax Returns to Contingency Operations**: The MFTRA extends to contingency operations designated by the Secretary of Defense the extensions of deadlines to file income tax returns and take other tax actions already available to members assigned to, or in direct support of operations in, combat zones and qualified hazardous duty areas.

-- **Impact**: The extension of deadlines to take certain tax actions, to include the filing of returns, formerly applied only to personnel serving in CZs and QHDAs or in direct support of operations in these locations. The new law enables the Secretary of Defense, or his designee, to extend to personnel serving in designated contingency operations the same extension of deadlines.

-- **Timeline**: The authority granted by this provision applies prospectively.

-- **Practice Tips**: As with direct support determinations with respect to combat zones, the designation of a contingency operation as qualifying for the extension of time to file individual income tax returns and take other tax actions will come in writing from an appropriate authority at the Office of the Secretary of Defense level. Local commanders and individual members do not have the authority to make this determination.

--- The deadline extension provision applies to the following tax actions: filing any return of income, estate, or gift tax (except employment and withholding taxes); paying any income, estate, or gift tax (except employment and withholding taxes); filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision; filing a claim for credit or refund of any tax; bringing a suit for any claim for credit or refund; making a qualified IRA contribution; allowing a credit or refund of any tax by IRS; assessment of any tax by the IRS; giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax; collection by the IRS of any tax due; and bringing suit by the United States for any tax due.

--- The deadline extension runs for at least 180 days after the later of:

---- 1) The last day the taxpayer is in a CZ, QHDA, or designated contingency operation (or the last day the area qualifies as such); or

---- 2) The last day of any continuous qualified hospitalization for wounds, disease, or injury sustained from service in the CZ, QHDA, or designated contingency operation (qualified hospitalization is hospitalization that resulted from an injury received while serving in the combat zone).

--- In addition to the 180 days and any period of qualifying hospitalization, the deadline is also extended by the number of days remaining for the member to take action with the IRS when he or she entered the CZ, QHDA, or designated contingency operation.

--- Some examples illustrate the calculation of the filing extension:

---- 1) A member in the CZ, QHDA, or designated contingency operation from 1 October 2003 to 1 May 2004 will have 285 days from the date he or she leaves the area to file the 2003 return. This extension equals the 180-day extension, plus the full 105 days of the tax-filing season because he was in the CZ or QHDA the entire filing season.

---- 2) A member in the CZ, QHDA, or designated contingency operation from 1 October 2003 to 15 January 2004 will have 285 days from the date he leaves the area to file the 2003 return. This extension equals the 180-day extension, plus the 105 days of the tax-filing season because he was in the area on 1 January. **Note -** If a member is serving in a CZ or QHDA, or in direct support of operations in a CA or QHDA, on **1 January**, he or she receives the **full 105 days** of the filing period as part of the deadline extension **even if** the return to home station occurs before 15 April.

---- 3) A member entering the CZ, QHDA, or designated contingency operation on 1 February 2004 and serving until 1 May 2004 will have 254 days from the date he leaves the CZ to file the 2003 return. This period of time is equivalent to the full 180-day extension, plus the 74 days remaining in the filing season when he entered the area.

---- 4) A member entering the CZ, QHDA, or designated contingency operation on 1 March 2004, serving until wounded and evacuated on 15 March 2004, and then hospitalized for treatment of the wound until 20 April 2004 will have 231 days in which to file the 2003 return. This period derives from the 15 days in the area, plus the 36 days of qualified hospitalization, plus the 180-day extension following the end of the hospitalization.

--- **Important:** This portion of the MFTRA applies only the extension of time to file individual income tax returns and take other tax actions to designated contingency operations. **Income earned by military members serving in these designated contingency operations will not be excluded from gross income.** The income exclusion rules apply only to members serving in CZs, serving in QHDAs, serving in direct support of operations in CZs, or flying missions in the airspace above CZs and QHDAs in support of operations in those areas.

- **Clarification of the Treatment of Certain Dependent Care Benefits**: The Act clarifies that child care benefits provided to military personnel are excluded from gross income for all tax years following 2002.

-- **Impact**: Two sections of the Internal Revenue Code come into play here. Under section 129, employees generally may exclude from taxable income up to $5,000 of employer-provided child care expenses. Section 134 of the same Code excludes from income benefits provided to members of the armed forces. Although they'd never previously been taxed, prior to the MFTRA it remained unclear whether child care benefits provided by the military to its members were intended to be included among the tax-free benefits addressed by section 134. Section 103 of the MFTRA resolves any confusion: military-provided child care benefits are excluded from gross income and thus not subject to taxation.

-- **Timeline**: This provision applies to all tax years from 2003 onward.

-- **Practice Tip**: Military members who use on base child care do pay a fee for that service. Generally, however, that fee falls below the cost of child care services in the civilian community. The difference between the cost of child on base and the fair market value of that care in the local area could have been deemed income to the military member. The MFTRA makes clear neither this difference nor any other form of child care benefit provided by the DoD or the military services to military personnel is taxable income.

- **Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts**: The Act creates an exception eliminating the additional 10% tax on distributions from Coverdell Education Savings Accounts (ESAs) or qualified tuition programs (so-called 529 Plans) where the distributions are due to the designated beneficiary's attendance at one of the service academies. The covered academies include the United States Air Force Academy, the United States Military Academy (West Point), the United States Naval Academy, the United States Coast Guard Academy, and the United States Merchant Marine Academy.

-- **Impact**: Coverdell ESAs and 529 Plans provide taxpayers a means to invest for future higher education expenses for designated beneficiaries. Earnings on amounts invested in these accounts are tax-free if used for qualified education expenses. The earnings become taxable income if paid to a recipient for any purpose other than qualified education expenses. A 10% additional tax also applies unless the designated beneficiary has received a tax-free scholarship.

--- The MFTRA eliminates the 10% additional tax not by treating service academy appointments as tax-free scholarships but by creating a specific exception to the applicability of this tax. Appointments to service academies are not tax-free scholarships because the appointee holds a service obligation. As a result, this benefit could not apply without the specific exception created by the new law.

--- **Important**: Where the designated beneficiary's attendance at a service academy prompts distribution of the amount in a Coverdell ESA or 529 Plan, regular income tax still applies to the earnings on the account. The exception created by MFTRA eliminates only the 10% additional tax.

--- An example illustrates how the exception works. Assume Mr. John Jenkins opened and invested in a Coverdell ESA over the years to create a fund to help offset some of his son Jack's future college education costs. Jack earns an appointment to the Air Force Academy and thus does not need the money in the account. If the proceeds are distributed to Jack, he must pay income tax on the $6,000 in earnings. However, because of the exception created by the MFTRA, Jack will not pay an additional 10% tax on those earnings.

--- The exception applies to the extent the distribution does not exceed the "cost of advanced education." Title 10, §2005(e)(3) defines this term as those costs directly attributable to advanced education, including tuition and other fees; the cost of books, supplies, transportation, room and board; and related miscellaneous expenses. Distributions of earnings on Coverdell ESAs and 529 Plans in excess of the "cost of advanced education" remain subject to both regular income tax and the additional 10% tax. Because of the high value of a service academy education, this situation should not commonly arise.

-- **Timeline**: This provision applies to tax years beginning after 31 December 2002. As a result, there is absolutely no retroactive effect. Taxpayers cannot amend prior year returns to reclaim the 10% additional tax paid on distribution of the amounts in a Coverdell ESA or 529 Plan where the designated beneficiary received a service academy appointment. The law at the time required payment of that tax. The new exception allowing avoidance of the 10% additional tax applies prospectively only.

-- **Practice Tips**: Where the designated beneficiary of a Coverdell ESA or 529 Plan will not use the principal investment and earnings for qualified education expenses because he or she earned a tax-free scholarship or service academy appointment, both regular income tax and the additional 10% tax can be avoided. If, within 60 days of the distribution, the taxpayer rolls the funds over into another Coverdell ESA for a member of the designated beneficiary's family who is under age 30, neither regular income tax nor the additional 10% tax applies.

--- Returning to the example used above, if Mr. Jenkins rolls over the distribution from the Coverdell ESA or 529 Plan for Cadet Jenkins into another Coverdell ESA for the cadet's sister Jenny, no tax will apply provided Jenny is under 30 at the time of the roll over.

--- On cadets at service academies, an issue arises each year that warrants attention. Military member parents with children at service academies will seek to claim them as dependents for exemptions on their federal individual income tax returns. The exemption amount is $3,050 per dependent in 2003, an amount that reduces the taxpayer's adjusted gross income and hence taxable income. As a result, the parents want this exemption.

---- Five tests apply in determining whether a person qualifies as a dependent for purposes of claiming an exemption. They are: the relationship or member of household test; the citizenship test; the joint return test; the gross income test; and the support test. Service academy cadets will generally meet the first four tests - child is a covered relationship not requiring residency in the parents' home all year; the cadet is either US citizens or have resided in the US for the entire year; the cadet generally is unmarried and not filing a joint return with another person; and, as a full-time student, the cadet may earn more than $3,050 during the year and remain eligible to be claimed as a dependent. The support test presents the problem.

---- To meet the support test, the dependent must receive more than half of his or her support during the year from the taxpayer, considering all sources of support. The value of the academy education, room, board, uniforms, and stipend fall within "all sources of support." They are provided by the US government, not the cadet's parent or parents. As a result, it is highly unlikely the parent/taxpayer will have provided more than 50% of the cadet's support during the year, with the possible exception of the first year when the cadet may have spent more than half the year at home.

---- Watch out for this issue. Military members with children at the service academies will believe they're entitled to a dependency exemption. This belief flows from the relationship test, which allows an exemption for a child who is a full-time student and under age 24. That test is only one of five and all five must be met to claim a person as an exemption. There is no service academy student exception to the support test. If, considering all support the cadet received, the value of the academy-provided education and support included, the parent or parents did not provide more than half the total support, the exemption is not allowed.

- **Above-the-line Deductions for Overnight Travel Expenses of National Guard and Reserve Members**: The MFTRA allows Reserve and National Guard members to take an above-the-line deduction--that is, directly from gross income--for **nonreimbursed** expenses when they have to travel away from home and stay overnight to attend Reserve and National Guard meetings.

-- **Impact**: The above-the-line deduction, or adjustment to gross income, includes overnight transportation, meals, and lodging expenses that are **not reimbursed** for Reserve and National Guard members who must travel **away from home more than 100 miles and stay overnight** for meetings. The rule limiting the deduction of expenses for meals to 50% of their cost continues to apply. The MFTRA does not alter this limitation at all.

--- Because the deductions are "above-the-line," they reduce gross income directly. They are reflected on the front page of the Form 1040 or 1040A. Most importantly, again because the deductions are "above-the-line," the Reserve or National Guard member need not itemize deductions to claim them.

--- Under previous law, these members could deduct these expenses only as employee business expenses. This status required the members to itemize deductions. Additionally, the expenses were deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceeded 2% of adjusted gross income, a significant limitation on their availability.

-- **Timeline**: This provision applies to tax years after 31 December 2002. Thus, its effect is prospective only. Reserve and National Guard members cannot amend prior year returns under this new rule to seek deduction of nonreimbursed transportation, meal, lodging expenses paid in previous tax years.

-- **Practice Tips**: Of note, the amount of the expenses deductible directly from gross income under this rule may not exceed the general federal per diem rate applicable to the locale. So, a member cannot incur excessive expenses in traveling for a Reserve or National Guard meeting to boost the amount of expenses deductible "above-the-line." Expenses incurred in excess of the federal government per diem rate may be deductible as miscellaneous itemized deductions. To qualify, however, the taxpayer must itemize deductions and the total of the miscellaneous deductions must exceed 2% of adjusted gross income.

--- The allowance of an above-the-line deduction for the unreimbursed overnight travel, meal (subject to the 50% limit) and lodging expenses potentially brings a significant benefit to taxpayers who itemize deductions. The amount of adjusted gross income determines eligibility for deductions, exemptions, and credits and reduces potential tax liability. For example, a lower adjusted gross income means a lower 2% figure in calculating ability to take miscellaneous itemized deductions (including employee business expenses) and a lower 7.5% figure for deduction of medical expenses.